



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.3.B.01/2006-13

July 7, 2006
06-PAC-023(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Compensation Costs Arising from Stock Options

Auditors should be alert to unallowable costs related to employee stock option awards when evaluating the contractor's incurred cost claims and forwarded pricing proposals, as described below.

For financial accounting purposes, effective June 15, 2005, FAS 123(R) requires companies to recognize the value of the employee's right to purchase the company's stock at a specified price (i.e., stock options) as compensation costs. FAS 123(R) requires that compensation costs for stock options awarded to the employees on or after June 15, 2005 be measured at their fair value on the grant date, i.e., the date the key terms and conditions of stock option awards are known. The fair value of the option is usually determined by the use of an option pricing model, such as the Black Scholes Merton Pricing Model.

The requirements of FAS 123(R) apply only to financial accounting and have no effect on the measurement and allowability of costs for Government contracts. Auditors should continue to evaluate the stock options awarded to contractor employees in accordance with CAS 415 and question any stock option cost claimed in excess of the amount measured under CAS 415 (for non-CAS covered contractors, auditors should cite FAR 31.205-6(k) when questioning the cost). CAS 415, which is incorporated at FAR 31.205-6(k) in its entirety, provides that compensation costs arising from stock options awarded to employees be measured by the difference between the fair market value of the stock and the option's exercise price at the measurement date. The measurement date is the first date when both the number of stock options awarded and the option price are known. Since we believe that many companies award stock options to their employees at an option price that is equal to or higher than the market price of the stock on the measurement date, there is generally no allowable compensation cost resulting from stock options awarded to employees under Government contracts. However, in rare instances where stock options are awarded at an option price that is lower than the market price on the measurement date, the difference constitutes compensation costs under CAS 415 and would be considered allowable, subject to the other provisions of FAR 31.205-6.

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact, Accounting and Cost Principles Division, at (703) 767-3248.

/Signed/
Terry M. Schneider
Deputy Assistant Director
Policy and Plans

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